

Raymond J. Keating
Chief Economist
Small Business Survival Committee
1920 L. Street N.W., Suite 200
Washington, D.C. 20036

Dear Mr. Keating:

In the Small Business Survival Committee's recent yearly report, Washington state ranked as the 8th most hospitable state in the nation for small businesses. Lauded by the state labor council, the ranking came as a great surprise to many in Washington's small business community. While policymakers in the state of Washington would love to tout this report, we do feel there is one flaw: namely, the report significantly understates the business and occupation tax's burden on Washington businesses, specifically in relation to how corporate income taxes are scored. This letter will explain how we came to this conclusion, and it is our hope that this can be corrected in next year's report.

A. Methodology

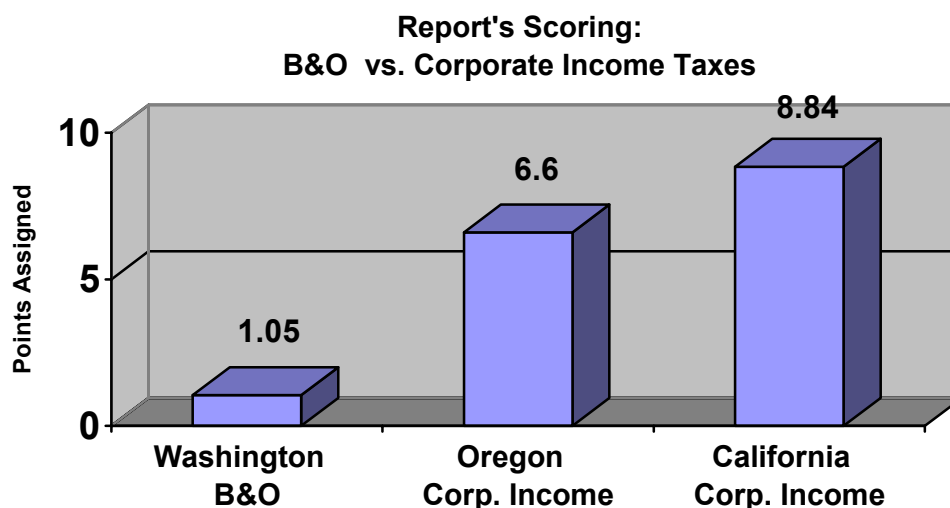
The Small Business Survival Committee's ("SBSC") report employs twenty-one measures, assigning a numerical value to each and summing the indicators for a state's total score. In terms of impact on the rankings, far and away the most significant indicators are a state's income tax rates. The importance the report places on income tax rates is reflected by the fact that the eight highest ranked states, including Washington, all lack a state income tax. But this, in and of itself, is not a flaw, but rather a policy choice that the SBSC is perfectly free to make.

B. Flaw: Unequal Treatment of the B&O

Our concern instead stems from the report's comparatively unequal treatment of the state's business and occupation ("B&O") tax, specifically in relation to how net corporate income taxes are scored. The state's B&O tax is unique in the nation, as it is based on a business' gross receipts rather than net profits. Since the tax is collected directly from businesses, its nearest equivalent in the report would be to a corporate net income tax. But the report instead places the B&O tax into a different category, entitled "Sales, gross receipts, and excise taxes." This category measures what percent a state's sales and excise tax collections are of the population's personal income. According to the report, Washington's sales and B&O taxes eat up 5.73 percent of Washingtonians' personal income; hence, Washington receives a score of 5.73 in that

category. The amount attributable solely to the B&O, however, is 1.05 percent.¹

Thus, comparing apples-to-apples, Washington's B&O tax is worth 1.05 points in the report. Meanwhile, Oregon's corporate income tax is scored at 6.6 points, California's corporate income tax is scored at 8.84, and nearly a dozen states have scores higher than nine.



Looking at these results, it becomes apparent the B&O is not fairly scored. The report finds Washington's B&O tax to be nine times friendlier than a 9 percent corporate income tax. Yet, tax analysts generally agree the B&O is more burdensome on small businesses than a net corporate income tax. This is because the B&O is imposed on all of a business' sales, whereas a corporate income tax is imposed solely on a business' profit. (The B&O tends to be preferable for highly evolved, highly profitable companies; yet for fledgling or smaller businesses, the B&O is a burden.)

To quote from our state Department of Revenue's own literature:

Negative features of the B&O tax are significant. Most importantly, it imposes a heavy burden on new and small businesses that may not have reached their maximum level of operating efficiency, or have yet to fully develop their markets, and as a result are unprofitable. Thus, the tax does not encourage economic development. As a result, established profitable firms are favored at the expense of new, start-up businesses. (*Tax Reference Manual – 2002, Washington State Department of Revenue, p. 92*)

Finally, to bring home the point about just how burdensome the B&O tax is for small businesses, on Oct. 3, 2003, the Washington Policy Center held a statewide small business conference with nearly 400 small businesses in attendance. *When polled about what changes they would like to*

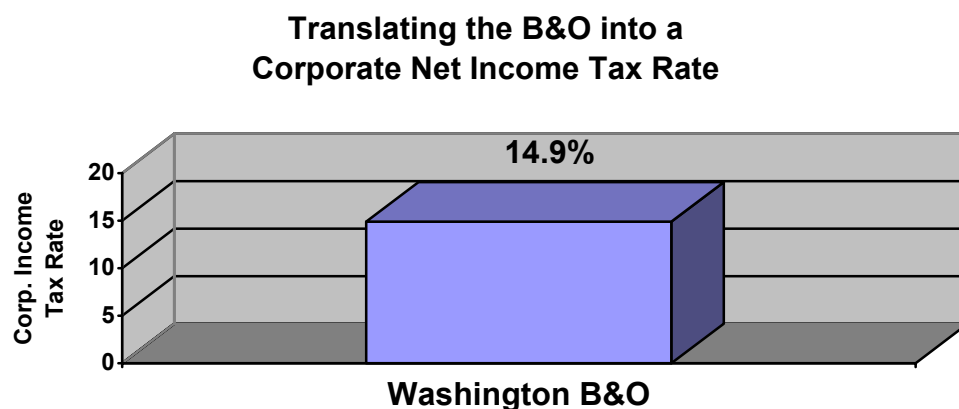
¹ Business & Occupation tax collections were \$2.012 billion in FY 01, according to Washington State's Department of Revenue, representing 1.05 percent of the state's personal income.

see to Washington's tax structure, the third highest vote-getter was to eliminate the B&O tax and replace it with a statewide personal and corporate income tax!

C. Revised Analysis: Washington's Ranking Drops to Below Average

The challenge in correcting for the report's inequitable B&O scoring is to translate the state's B&O tax—which is on gross receipts—to an equivalent net corporate income tax rate. Only when this is done can the burden on Washington's small businesses accurately be compared and contrasted to other states.

The way to do this is to ask, "What corporate income tax rate would be needed in Washington to replace the B&O but still generate the same revenue for the state?"



Thankfully, the Department of Revenue developed just such a tool for this purpose, called "SimTax." (http://dor.wa.gov/content/WAtaxstudy/Tax_Design.htm) The answer SimTax churns out is that, in order to generate the same revenue as the B&O tax, a corporate net income tax of 14.9 percent would have to be imposed on every business in the state. (Note that such a rate is higher than any state imposes, indicating the current burden of the B&O to be very significant on Washington businesses.)

This would, consequently, translate to a score of 14.9 points for Washington's B&O tax vs. its 1.05 points in the current report. The net impact would be a 13.85 point increase in the state's score.

This increase would drop Washington's ranking from 8th to 32nd, with a total score of 47.06.

Small Business Survival Index 2003		
(Revised to Accurately Reflect B&O Burden)		
Rank	State	Total Score
26	OK	44.44
27	KY	44.864
28	ID	44.92
29	MA	45.785
30	WI	46.445
31	KS	46.81
32	WA	47.06
33	ND	47.665

D. Conclusion

We feel the SBSC report does not accurately capture the burden Washington state's B&O tax places on small businesses in this state. Tax analysts generally agree the B&O is more burdensome on small businesses than a net corporate income tax, yet the SBSC report finds Washington's B&O tax to be nine times friendlier than a 9 percent corporate income tax. (If the report's findings were true, small businesses would not consider lobbying for the institution of an income tax to replace the B&O.)

To remedy this inequity, we encourage the SBSC to translate the state's B&O to an equivalent net corporate income tax rate. This is readily done, thanks to SimTax. We strongly feel this is the only way for Washington to accurately be compared and contrasted to other states.

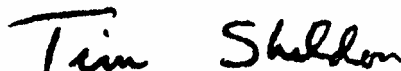
Confusion regarding proper treatment of the state's B&O was to be expected, as the tax is unique in the nation. We hope, though, this letter illuminates the issue, and we look forward to your analysis of its contents.

Thank you for your attention to and consideration of this matter.

Sincerely,



Sen. Bill Finkbeiner, R-Kirkland, WA
Deputy Senate Majority Leader
Washington State Senate



Sen. Tim Sheldon, D-Potlatch, WA
Chair, Senate Economic Development Committee
Washington State Senate